BRAZIL MACRO

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MONETARY POLICY – COPOM MEETING

A PLAN AMID THE UNCERTAINTY

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- The COPOM once again hiked the Selic rate, but this time at a magnitude of 100 bps, taking the policy rate to 11.75%, the highest level since 2017. The decision was in line with analysts and the most likely scenario implicit in the yield curve.
- While the BCB recognizes the persistently unfavorable current inflation conditions and the deterioration in the inflation outlook owing to the supply shock generated by the Russia-Ukraine conflict, an alternative BCB scenario assuming nearly flat oil prices in real terms, departing from USD 100 per barrel at YE2022, leads to an IPCA estimate of 3.1% for next year, assuming terminal Selic of 12.75%.
- The authority interprets this as a signal that an additional 100 bps – indicated by the authority as the likely outcome for the May 3-4 policy meeting – could eventually suffice for the BCB's objective to bring inflation to the mid-target of 3.25% for the relevant policy horizon (2023 from now on). The asymmetry in the balance of risks (still tilted to the upside) is not seen as enough for additional moves at this stage.
- Yet the authority recognizes the very high level of uncertainty regarding the size and duration of the current shocks and continues to pledge doing what is necessary to achieve the mid-target in the relevant horizon. The BCB sought to make explicit its flexibility to change the flight plan and eventually "adjust the size of the monetary tightening cycle." The BCB recognizes that the second-round effects (read further increases in inflation expectations), which are admittedly the focus of BCB actions now (amid such supply shocks affecting commodity prices), may take a while to show.
- In our view, these second-round effects may continue to materialize in coming weeks, with further gains in inflation expectations probably making the BCB end the cycle at a slightly higher level than planned now. Thus, we now take the opportunity to update our Selic rate projections (last revised in the eve of the start of the war in Eastern Europe) and revise our expected terminal level to 13.25% (prior: 12.50%). We now expect two more hikes (of 100 bps in May and 50 bps in June). Our YE 2023 forecast has also been raised.

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In its 245th monetary policy meeting, the COPOM[1] once again hiked the Selic rate, but this time the increase was at a magnitude of 100 bps[2], compared to 150 bps in the three previous occasions. The move takes the policy rate to 11.75%, the highest level since 2017. The decision was in line with the vast majority of analysts and was the most likely outcome implicit in the yield curve. This is the ninth consecutive hike in this tightening cycle—which started with the Selic at 2.00% about a year ago.

Policy Decision and Flight Plan

In our view, the COPOM sought to moderately respond to the continued deterioration in the inflation outlook, but tried to avoid signs of overreaction, at least for now, amid a sea of uncertainty in global and local conditions.

Firstly, the BCB recognizes the deterioration in the global environment on the heels of geopolitical developments of late (Russia-Ukraine war). The BCB cites "strong tightening in financial conditions and higher uncertainty," but particularly notes that the "the supply shock resulting from the conflict has the potential of increasing inflationary pressures."

All of that occurs amid a backdrop of local inflation conditions still seen as adverse by the COPOM, with the BCB keeping the assessment that CPI continued to surprise negatively both in volatile and core items. The latter are still seen running "above the range compatible with meeting the inflation target."

Yet the deterioration in inflation expectations of late, the high numbers of underlying inflation trends – pointing to a broadening of upward price pressures – and the emergence of a new global price shock have not necessarily led to a deterioration in the BCB's inflation projections for the relevant policy horizon (read mainly 2023), which is partly due to the incorporation of expectations of a tighter monetary policy response.

According to the BCB's own inflation models, with the FX rate starting at 5.05 (and moving along with PPP afterward), IPCA inflation would stand at 7.1% for 2022 (previously: 5.4%; mid target: 3.50%; upper target: 5.00%) and at 3.4% for 2023 (previously: 3.2%; mid-target: 3.25%; upper target: 4.75%). This is the so-called "reference scenario," whose results assume the following path for the Selic rate, as per the consensus of economists[3]: hike of 75 bps (to 12.50%) for May and an increase of 25 bps (to 12.75%) for June, with rate stability at 12.75% afterwards. Rate cuts are expected to start in March 2023, taking the Selic down to 8.75% for YE2023. The reference scenario also assumes yellow flag for electricity tariffs both for YE2022 and YE2023. This scenario also yields projections for administered prices that largely beat the current consensus of economists, as per the Focus report: 9.5% for 2022 (consensus: 5.6%) and 5.9% for 2023 (consensus: 4.5%).

Given what the BCB sees as an elevated uncertainty and volatility about the oil price outlook, the authority apparently did not feel comfortable with their own usual assumptions and methodology about the incorporation of oil costs in their inflation estimates. And that made the authority simulate an alternative scenario, judged as more likely by the committee. This one uses a path where "oil prices follow approximately the futures market curve until the end of 2022, ending the year at USD 100/barrel, and then start increasing 2% per year in January 2023." In this alternative scenario, the BCB estimates IPCA 2022 at 6.3% and IPCA 2023 at 3.1%, thus leading to conditions where a terminal Selic of 12.75% would take IPCA to mid-target in 2023.

The result of this "alternative" scenario, seen as more probable by the BCB, seems to have prompted some comfort among BCB officials, as they claim that the "current projections indicate that the interest rate cycle in its scenarios is sufficient for inflation convergence to levels around the target over the relevant horizon." With the BCB foreseeing another move of 100 bps (to 12.75%) for its May 3-4 policy meeting, in theory, this could mean that the current BCB flight plan is to deliver such an adjustment and then end the cycle at 12.75%.

This plan could also be strengthened by an apparently less hawkish view on the balance of risks for inflation. According to the COPOM statement, the authority continues to see "an upward asymmetry in the balance of risks" for inflation, following "uncertainties regarding the fiscal framework" and "the risk of de-anchoring inflation

[1] The COPOM is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the statement of COPOM #245 in English (https://www.bcb.gov.br/en/monetarypolicy/COPOMstatements).
[3] Refer to the BCB's weekly survey of professional forecasters for March 11, 2022 (https://www.bcb.gov.br/en/publications/focusmarketreadout)

expectations." However, the BCB mentions that part of the upward risk has already been partly "incorporated in the inflation expectations and asset prices used in its models." This means that the upward bias for their own inflation projections could have diminished, according to the BCB's assessment.

In any case, the BCB does not seem overly confident on that assessment, in our view. Firstly, the BCB recognizes the lagged materialization of the second-round effects from the supply shocks affecting commodity prices: and combating those is the aim of the COPOM, as the BCB highlights. Secondly, the BCB admits the difficulty in anticipating some key developments for the inflation outlook, and pledges to revise the flight plan if needed. In their own words, the committee judges that "the moment requires serenity to assess the size and duration of the current shocks. If those shocks prove to be more persistent or larger than anticipated, the Committee will be ready to adjust the size of the monetary tightening cycle." Lastly, the COPOM reinforced the message that it sees appropriate "to **continue advancing** in the process of monetary tightening significantly into an **even more** restrictive territory."

What to Expect Ahead?

We take the opportunity to update our Selic rate outlook. Our last outlook review dates from February 24 – around the start of the war in Eastern Europe – so that our Brazil macro outlook still does not account for this important shock on key variables, especially commodity prices and inflation expectations. As we wait for geopolitical developments to get more clarity on temporary and structural changes in the global economic environment, we can gradually proceed with partial updates to our numbers.

Based on what we know now, we update our Selic rate forecast to reflect a hike of 100 bps in May (to 12.75%) and a last move of 50 bps (to 13.25%) in June. Our expectation for this last move follows our view that inflation expectations for 2023 may continue to rise a bit for the coming weeks. For now, our terminal Selic estimate stands at 13.25%, with a subsequent stabilization in inflation expectations being key for the materialization of this call.

The upward revision for interest rate at the end of this tightening cycle naturally has implications for the entire trajectory that we expect for the Selic rate across next year and a bit beyond: we now forecast rate cuts to start in March 2023, taking the Selic rate down to 10.00% for YE2023 (we previously forecasted 9.00%) and 7.00% for YE2024 (now to be reached in 3Q24, instead of 2Q24).

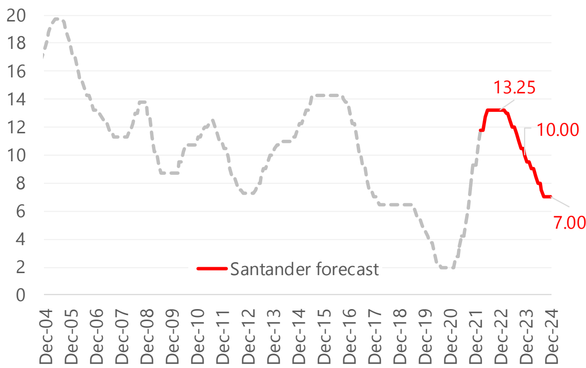
But this expected convergence to the structural level of 7.00% is conditional on the maintenance of a long-term inflation target of 3.00%. An eventual (upward) revision of the long-term target[4] would naturally imply a higher structural level of the Selic rate both in nominal and real terms[5].

Refer to a few graphs in the next page.

[4] The CMN Monetary Council sets the inflation target for three years in advance (and can revise the targets for the first two years). External and domestic (fiscal policy) shocks are feeding a debate among local economists, as some discuss the need for an eventual (upward) revision of the targeted path – for now, the long-term target is 3.00% for 2024. In June 2022, the CMN will re-discuss the targets for 2023 and 2024 and set the number for 2025. In our view, the target should be left as is, since it is up for economic policy as a whole to adjust to the current inflation targets (which seem quite in line with peer-economies in the same region), and not the other way around.

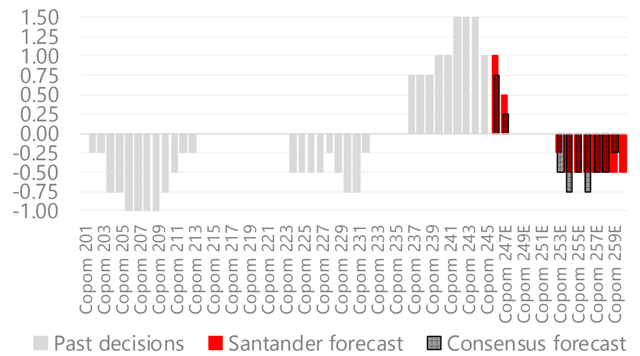
[5] Real structural interest rate could also be impacted by a higher inflation target, owing to a higher inflation risk premium component.

Figure 1. The Path for the Selic Policy Rate (monthly average, % p.a.)



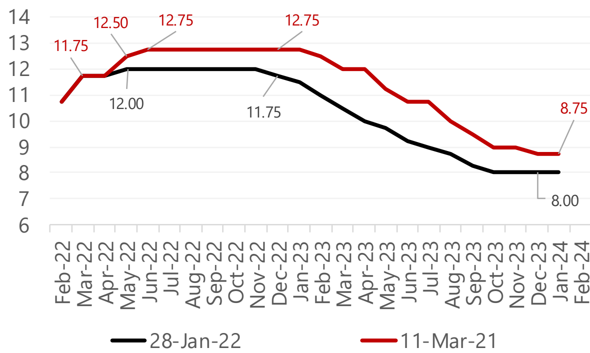
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 2. Selic Rate Moves in COPOM Meetings: History and Forecast (in percentage points)



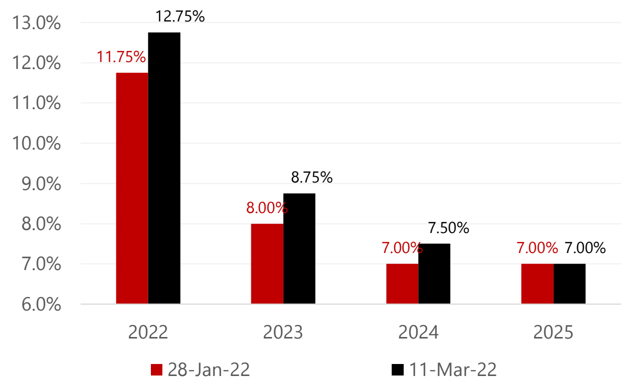
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 3. Median Monthly Selic Forecasts (Consensus)



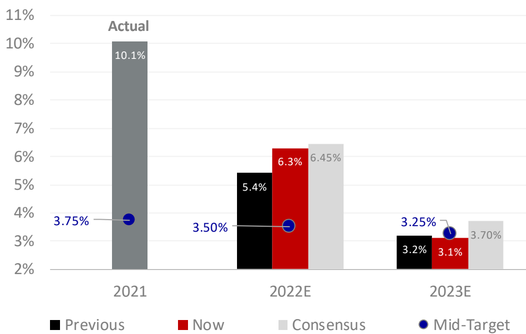
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 4. Median Annual Selic Forecasts (Consensus)



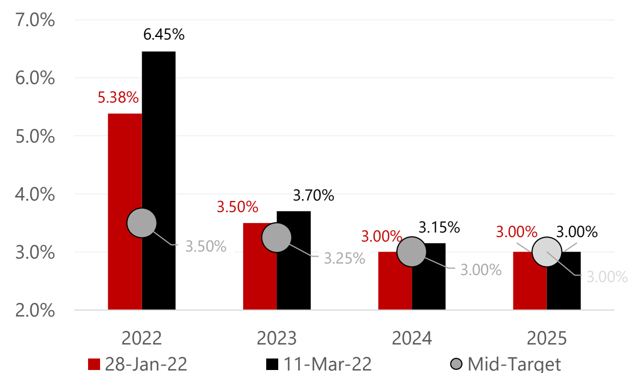
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 5. BCB's Inflation Simulation – Alternative Scenario (% annual)



Sources: Brazilian Central Bank, Santander.
Note: IPCA simulations assume Selic rate from the Focus survey and USD/BRL starting at 5.05 and evolving according to purchase power parity. Assumes oil price at USD 100 by YE2022 and a 2% change per year afterwards.

Figure 6. Median Annual IPCA Forecasts (Consensus)



Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

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